Lethame Capital Management

Technology : Research : Investing

Reconsidering Government Deficits: A Balance Sheet View of Fiat Money – Part 2

Summary

Government deficits are not signs of fiscal irresponsibility but the operational means by which net financial assets enter the private sector. Every government deficit is, by definition, a private sector surplus. Yet deficits alone do not explain why government-issued money retains value. That role belongs to taxation, which creates demand for the currency and anchors its worth.

Introduction

In our earlier analysis we established that when governments spend more than they tax, they inject net financial assets into the private sector. This is not a theoretical claim but an accounting reality: the government's deficit is the private sector's surplus.

The critical follow-on question is: if deficits add wealth to the private sector, what gives that wealth value? Why do people accept government money in exchange for goods and services, when governments can issue more at will? The answer lies in taxation.

Deficits and Surpluses: The Accounting Symmetry

In a sovereign monetary system, the financial positions of the government and the private sector are mirror images. When one sector's equity rises, the other's falls.

- If government spending exceeds taxation, private sector bank deposits and reserves rise—government deficit, private surplus.
- If taxation exceeds spending, deposits fall and private financial wealth is destroyed—government surplus, private deficit.

Private banks unquestionably create money when they lend. A loan simultaneously generates a deposit for the borrower (a new asset for the private sector) and a liability to the bank. This expands the volume of deposits and increases purchasing power in the economy.

But at the aggregate level, the private sector's **net financial position does not change**: every new deposit created by a loan is matched by an equivalent private liability. The balance sheets grow in size, but net to zero across the private sector as a whole.

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By contrast, when the government spends more than it taxes, it credits private deposits without creating a corresponding private liability. Instead, the liability sits with the government. This means government deficits expand the private sector's **net financial wealth**. Surpluses do the opposite: by taxing more than they spend, governments withdraw deposits and reduce private sector wealth.

This is the central insight of our research: **government deficits add to private sector wealth, while government surpluses drain it.**

What is the point of Taxation?

If deficit spending injects wealth, taxation ensures that wealth holds value. Taxes perform two vital functions:

1. **They create demand for the currency.** Because taxes can only be settled in the state's money, households and firms must obtain that money. This makes the currency universally desirable, even if it has no intrinsic value.
2. **They regulate aggregate demand.** By withdrawing purchasing power from the economy, taxation prevents government spending from exceeding the real capacity of the economy and driving inflation.

Double-entry accounting makes it clear that taxation is not required to "fund" government spending. When the Treasury spends, it credits private bank deposits and creates corresponding reserves in the banking system. The private sector's assets rise, matched by a liability on the government's books. No prior tax revenue is needed for this process: the act of spending itself creates the deposits and reserves. Taxation is simply the reverse entry—it reduces private deposits and bank reserves, and restores government equity. Crucially, spending and taxation are independent operations: the state does not need to collect deposits before it can create them, just as a bank does not need to attract deposits before making a loan. The accounting identity ensures that deficits increase the private sector's net financial wealth, while taxation merely alters its distribution and maintains the value of the currency.

Historical evidence supports this institutional view. **Desan (2014)** shows that in post-imperial Europe, sovereigns rebuilt fiscal capacity by issuing coin and, crucially, by denominating taxes, dues, and legal obligations in that unit. The enforceable need to obtain the ruler's money to discharge public obligations created baseline demand for the currency independent of any intrinsic metal value, Silver in this instance. The transition from paying obligations "in kind" to paying them in money simultaneously extracted real resources for the public realm and left behind a circulating token that enabled private exchange. In modern terms, taxation anchors the value of a fiat currency and sustains its acceptability, while the tax-and-spend cycle calibrates demand to real capacity.

Thus, taxation is not primarily a way of "financing" government. A sovereign government does not need prior revenue in its own currency. Instead, taxes sustain the value of the money already created by deficits.

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Box: Competing Views on Taxation

Mainstream View

- Taxes fund government spending.
- Without taxation, the state would lack revenue to spend.
- Deficits therefore reflect borrowing from the public, potentially "crowding out" private investment.

Lethame Capital View

- Taxes do not fund spending for a currency-issuing government.
- Government creates money through spending; taxes withdraw it to maintain value.
- Deficits add private wealth; taxation ensures that money remains desirable and stabilises demand.

The Symbiotic Relationship

This reframing alters how we think about the state. Taxation is not parasitic, as mainstream and Austrian economists often claim, but symbiotic. Government spending injects net assets into the economy; taxation preserves their value and stabilises the system.

Without deficits, the private sector cannot expand its net financial wealth. Without taxes, the money created by deficits loses its anchor of value. Together, deficits and taxation form the twin pillars of a functioning fiat money system.

Conclusion

The logic is clear: deficits add, taxes sustain. Government deficits are the means by which private wealth is created; taxation is the mechanism by which that wealth retains value.

Recognising this dual role dispels two persistent myths: that deficits represent fiscal excess, and that taxes are needed to fund government. In reality, deficits and taxation work together, one providing the injection of financial assets, the other ensuring those assets remain valuable. Misunderstanding this symbiosis leads not only to poor policy but also to flawed investment strategies.

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